No. 11834

In the United States Circuit Court of Appeals for the Ninth Circuit

J. W. MALONEY, United States Collector of Internal Revenue for the District of Oregon, Appellant,

v.

C. B. SPENCER, Appellee

UNITED STATES OF AMERICA, Interpleader-Appellant

On Appeal from the District Court of the United States for the District of Oregon

BRIEF FOR THE COLLECTOR AND THE UNITED STATES

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BRIEF FOR THE COLLECTOR AND THE UNITED STATES

OPINION BELOW

The District Court wrote no opinion.

JURISDICTION

This appeal involves individual income taxes of the appellee (hereinafter called the taxpayer) for the fiscal

year ended February 29, 1944. (R. 3, 6-42, 69, 78.) The aggregate amount of taxes[1] in dispute was assessed (together with victory taxes) pursuant to the taxpayer's amended income and victory tax return filed for such taxable year on or about June 15, 1944, and was paid to and collected by the Collector on or about October 8, 1943, February 19, 1944, and March 22, 1945. (R. 3, 69.) A claim for the refund thereof was timely filed by the taxpayer on or about April 21, 1945, and more than six months had elapsed between the dates of filing the claim and the filing of this action without any notice of allowance or rejection of the claim having been sent to the taxpayer in the meantime by the Commissioner of Internal Revenue. (R. 4, 78.) On

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(1) The exact amount of the tax in dispute is not ascertainable from the record. The suit was brought for the recovery of income taxes paid for the fiscal year ended February 29, 1944, in the sum of $93,565.04. (R. 2-5.) The District Court indicated in its findings of fact that the taxpayer had "overpaid" his income taxes in the amount of $78,659.03 (R. 78), which it held the taxpayer is entitled to recover, with interest according to law and costs (R. 81), and thereupon entered judgment in favor of the taxpayer for such amount accordingly (R. 83-84). Inasmuch as the court below decided all three issues involved in the case in favor of the taxpayer (R. 79-82), and the Government's appeal involves only the first issue (R. 87-89), the precise amount of income tax relating to and dependent upon the decision of that issue is not determinable from the record. The correct amount, however, will eventually be determined by the Collector according to the final outcome of the case.

October 27, 1945, within the time provided by Section 3772 of the Internal Revenue Code, the taxpayer brought this suit for the recovery of the taxes in dispute and interest according to law. (R. 2-42.) Jurisdiction was conferred upon the District Court by Section 24, Fifth, of the Judicial Code, as amended. The judgment was entered on June 24, 1947, in favorof the taxpayer, with costs (R. 83-84.) Thereafter, within three months, notice of appeal was filed by the Collector and the United States, as interpleader, on September 19, 1947. (R. 85.) The jurisdiction of this Court is invoked by the provisions of Section 128 (a) of the Judicial Code, as amended.

QUESTION PRESENTED

Whether the taxpayer was entitled to carry back to the taxable year ended February 29, 1944, the net operating losses alleged to have been sustained during the fiscal year ended February 28, 1945, within the meaning of Section 122 of the Internal Revenue Code.

Determinative of this issue are the questions (1) whether the taxpayer was engaged in a statutory trade or business regularly carried on by him by financing only his three wholly-owned and controlled cannery corporations during the taxable year, and (2) whether the taxpayer's extension of his credit, by endorsing their notes, to finance his three wholly-owned and managed canneries represented ordinary debts or capital investments.

STATUTE INVOLVED

This is set forth in the Appendix, *infra.*

STATEMENT

The pertinent facts in respect of the issue appealed herein, as found by the District Court (R. 67-79), may be summarized sufficiently for present purposes as follows:[2]

At and during all times hereinafter mentioned, the taxpayer was and now is a resident of the State of Oregon. During the taxable year ended February 28, 1943, and prior thereto, he was engaged in the business of operating a cannery in the State of Oregon, and another cannery in the State of Washington. During the taxable years ended February 29, 1944, and February 28, 1945, he was engaged in the business of acquiring, owning, expanding, equipping and leasing food processing plants, and providing, through guarantee and otherwise, adequate financing of the operations of such plants; and such business during those times

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(2) The facts pertaining to the other two issues, not appealed herein, and other detailed facts, figures, etc., not important to a determination of the issue, have been omitted from the statement of facts for the sake of brevity.

was regularly carried on by the taxpayer for profit.[3] (R. 67-68.)

At and during all the times hereinafter mentioned the taxpayer kept his books of account and made his income tax returns on the accrual and fiscal year bases, his fiscal year beginning on the first day of March and ending on the last day of the following February of each calendar year. (R. 68-69.)

On or about June 15, 1944, the taxpayer filed with the Collector an amended individual income tax return (Form 1040) for the taxable year ended February 28, 1943, evidencing a total income tax liability in the sum of $141,722.80 for that year; and also an individual income and victory

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(3) We object to this and the other ultimate findings of fact, and the District Court's conclusions in respect thereto (R. 79-81, paragraphs II, III, V, and VIII), to the effect that the taxpayer was engaged in the business of financing cannery corporations, and that his advancements and guarantees of their obligations to them constituted debts rather than capital investments (R. 72, 79-80). We submit and show hereinafter that these findings and conclusions were erroneously drawn from various subordinate facts and are not supported by the undisputed primary facts, and that the conclusions drawn therefrom are contrary to the undisputed facts, the law and the authorities, as set forth in our statement of points to be relied on upon appeal (R. 87-89), and are therefore subject to revision, correction and reversal upon appeal by this Court. (See also fns. 5-9, 13 and 14, *infra.*)

tax return (Form 1040) for the taxable year ended February 29, 1944, evidencing a combined income and victory tax liability in the sum of $152,619.84 for the taxable period beginning March 1, 1942, and ended February 29, 1944. Pursuant to such returns, the taxpayer paid to the Collector the sums of $76,297.91 and $1,394.59, $76,297.91, and $214.53 on or about October 8, 1943, February 19, 1944, and March 22, 1945, respectively. Those payments fully paid all the tax liability of the taxpayer as evidenced by such tax returns. (R. 69.)

On or about April 21, 1945, the taxpayer filed with the Collector his individual income tax return (Form 1040) for the taxable year ended February 28, 1945,[4] evidencing no tax liability for that taxable year but rather a net loss in the sum of $127,052.35, incurred in the taxpayer's above-mentioned business.[5] (R. 69.)

During the taxable year ended February 28, 1945, Spencer Dehydrator, Inc., of Lebanon, Oregon, an Oregon corporation, owed the taxpayer the sum of $61,115.48, on account of accounts payable of this corporation which the taxpayer had previously guaranteed and paid, and on ac-

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(4) Reference hereinafter to the taxable years 1943, 1944 and 1945 shall be understood to mean the taxable years ended on the last day of February of those years.

(5) We likewise object to this finding in respect of "the taxpayer's above-mentioned business", for the same reasons stated in fn. 3, *supra*.

count of notes payable of the corporation upon which the taxpayer was surety and which he paid. Also during that taxable year the Spencer Packing Company of Yakima, Washington, a Washington corporation, owed the taxpayer the sum of $33,966.02 on account of unpaid rent, sums advanced by the taxpayer to that corporation to pay promissory notes of the corporation upon which the taxpayer was surety which were used by it to pay the notes, lug boxes rented to the corporation by the taxpayer and not returned by it to him because they had become broken, and money belonging to him and collected but not paid over to him by the corporation. The sums owed the taxpayer by those corporations were unpaid balances on open accounts receivable of the taxpayer and not open accounts payable of the corporations, and were debts which arose in the course of the taxpayer's above business but were not contributions to the capital of those corporations or to the capital of either of them.[6] Each of the corporations was completely liquidated within the taxable year ended February 28, 1945, and since February 15th of that year neither of them has engaged in any business or had any income or assets. Prior to the liquidation of those corporations, they were engaged

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(6) We likewise object to this finding in respect of, "The sums * * * were debts which arose in the course of the taxpayer's above business but were not contributions to the capital of those corporations or to the capital of either of them", for the reasons stated in fn. 3, *supra.*

in the business of food processing. Each and the whole of the above-mentioned debts became worthless in that taxable year, and the loss sustained by the taxpayer from the worthlessness thereof was incurred by him in such business and was attributable to the operation of such business regularly carried on by the taxpayer.[7] (R. 71-72.)

In the taxpayer's return for the taxable year 1945, a deduction was taken for bad debts in the amount of $107,567.51, which was for the two debts mentioned above. At the time the return was made, the taxpayer's books showed that the amount owed him by the Spencer Dehydrator Corporation was $73,601.49, which, together with the other sum of $33,966.02 owed him by the Spencer Packing Company, made up the aggregate amount of $107,567.51. The sum of $73,601.49 represented the balance due the taxpayer after applying all available credits against his account with Spencer Dehydrators, Inc., except that there was erroneously included in such balance the sum of $223.21 which was due and owing by the taxpayer during that taxable year on account of taxes on real and personal property. Such taxes, however, were against the Dehydrator plant which the taxpayer was renting to that corporation in the course of his business. One of the credits to Spencer

(7) We likewise object to this finding in respect of "the operation of such business regularly carried on" by the taxpayer, for the reasons stated in fn. 3, *supra*.

Dehydrator, Inc., was for its account against the Commodity Credit Corporation, which account the taxpayer had taken over. Subsequent to the filing of the return and the refund claim mentioned hereinafter, an audit of that account was made by representatives of the Commodity Credit Corporation, and it was determined thereby that the Commodity Credit Corporation owed $12,262.82 on that account, in addition to the amount shown on the books of Spencer Dehydrators, Inc., on February 15, 1945, when the account was taken over as a credit by the taxpayer. Such sum was entirely earned by Spencer Dehydrator, Inc., which was entitled to receive it from the Commodity Credit Corporation prior to February 15, 1945. It was applied as a further credit and, with the above taxes, it reduced the taxpayer's bad debt against Spencer Dehydrator, Inc., from $73,601.49 to $61,115.46 as specified above, and thereby reduced his total bad debts for the taxable year from $107,567.51 to $95,081.48. (R. 72-74.)

The taxpayer's gross income from his business for the taxable year 1945 was $33,562.28. He took business deductions for that year in the sum of $17,217.72, about which there is no dispute. This amount, together with the above two bad debts of $95,081.48, taxes of $223.21, and depreciation of $31,617.89, gave the taxpayer business deductions for that year in the aggregate sum of $144,140.33. His net loss attributable to the operations of his above

business[8] for that taxable year was $110,578.05. (R. 75.)

During the taxable year 1945, the taxpayer sold property which had been held by him for more than six months and realized a gain therefrom in the total sum of $17,141,39. There are no other gains, losses or deductions to be taken into account in computing the taxpayer's "net operating loss" for that taxable year, in accordance with the provisions of Section 122 of the Internal Revenue Code. The taxpayer sustained a "net operating loss" for that year, and a "net operating loss carry-back" for the taxable years 1943 and 1944, within the meaning of Section 122, in the sum of $93,436.66 which was incurred in and was attributable to the operation of the above business regularly carried on by him.[9] (R. 75.)

Prior to having sustained the above-mentioned "net operating loss carry-back" for 1943 and 1944 (R. 75), and by April 21, 1945 (when he filed his 1945 tax return (R. 69)), the taxpayer had paid to the Collector the total amount of $152,619.84 on account of his combined income and victory tax liability for the taxable period ended February 29, 1944, as shown above (R. 69). He overpaid his

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(8) We likewise object to this finding in respect of "the operations of his above business" for the reasons stated in fn. 3, *supra.*

(9) We likewise object to this finding in respect of "the operation of the above business regularly carried on by him", for the reasons stated in fn. 3, *supra.*

income and victory tax liability for that taxable period in the sum of $78,659.03, and the Collector has not refunded such amount or any part thereof to the taxpayer.[10] (R. 78.)

On or about April 21, 1945, the taxpayer filed with the Collector a claim for the refund of $93,565.04, which was based on the ground presented in the complaint herein (R. 2-42), namely, that he is entitled to the "net operating loss carry-back", and that the recomputation of his income and victory taxes for the taxable period ended February 29, 1944, including the "net operating loss carry-back", results in an overpayment of his income and victory taxes for that period. More than six months elapsed from the filing of the claim to the date of the filing of this action, and no notice of allowance or disallowance thereof has been received by the taxpayer from the Commissioner of Internal Revenue. (R. 78.)

Upon the basis of the foregoing facts the District Court held that the taxpayer was engaged in the business regularly

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(10) We object to this finding, of course, as being an erroneous conclusion drawn from the several adverse findings of fact which we consider wrong and contrary to the undisputed facts, the statute and the decisions, as hereinafter shown in our argument.

carried on by him of guaranteeing the operations of his three wholly-owned corporations during the taxable years 1944 and 1945, and that therefore he was entitled to carry

back to the taxable year 1944 the net operating losses alleged to have been suffered in 1945, within the meaning of Sections 23 (k) (4) and 122 of the Internal Revenue Code (Appendix, *infra*). (R. 79-80.) The District Court thereupon entered judgment, with costs, in favor of the taxpayer (R. 83-84), from which the Collector and the United States, as interpleader, appealed to this Court for review (R. 85).

STATEMENT OF POINTS TO BE URGED

The District Court erred (R. 87-89):

1. In finding and concluding that the taxpayer was, during the taxable year, engaged in the trade or business, regularly carried on by him, of financing, acquiring, owning, expanding, equipping and leasing food processing plants.

2. In finding and concluding that the sums advanced by the taxpayer to or on behalf of the corporations here involved, the Spencer Dehydrators, Inc., of Lebanon, Oregon, and the Spencer Packing Company of Yakima, Washington, constituted bad debts and did not constitute capital investments by the taxpayer in those corporations.

3. In concluding that during the taxable years ended February 28, 1943, February 29, 1944, and February 28, 1945, the taxpayer was engaged in a business regularly carried on by him within the meaning of Section 23 (k) (4) and Section 122 (d) (5) of the Internal Revenue Code.

4. In concluding that the sums of $61,115.46 and

$33,966.02 were owed to the taxpayer by the Spencer Dehydrators, Inc., and the Spencer Packing Company of Yakima, and that such amounts were debts which became worthless within the taxable year ended February 28, 1945, and concluding that the taxpayer incurred a loss in a business regularly carried on by him during that period in the total sum of $95,081.48, from worthless debts, within the meaning of Section 23 (k) of the Internal Revenue Code.

5. In concluding that the taxpayer was entitled to a net operating loss carry-back, within the meaning of Section 122 of the Internal Revenue Code, for the taxable period begun March 1, 1942, and ended February 29, 1944, in the sum of $93,436.66.

6. In granting judgment in favor of the taxpayer and against the United States to the extent that the judgment was based on the allowance of the aforementioned net operating loss carry-back under Section 122 of the Internal Revenue Code.

SUMMARY OF ARGUMENT

The taxpayer is not entitled to carry back and deduct from the income of the taxable year 1944 the losses allegedly suffered in 1945 for the right to such carry-back is limited by the statute to losses "attributable to the operation of a trade or business regularly carried on by the taxpayer". The District Court's findings and conclusions to the con-

trary are directly opposed to the undisputed facts showing that the taxpayer was not engaged in such business, generally, within the meaning of the terms of the statute and the decisions. The taxpayer, the sole stockholder of his three cannery corporations, financed and guaranteed only *their* operations and obligations, respectively, not those of other canneries or corporations generally. Therefore, he was not engaged in carrying on such business regularly. While the taxpayer, as sole stockholder, completely controlled and dominated the three corporations, their businesses were not *his* businesses. Accordingly, it follows that the losses resulting from the several canneries' liquidation and their consequent inability to repay the taxpayer were merely isolated capital transactions which were not attributable to the operation of a trade or business regularly carried on by the taxpayer, within the meaning of the statute and the controlling decisions.

The taxpayer's advances and extension of his credit to his three wholly-owned cannery corporations represented capital contributions and not bad debts owed him by them. Without his meeting the burden of proving that he was regularly engaged in the above-mentioned business *and* that the guaranteed corporate obligations and accrued rentals represented bad debts and not capital investment, the taxpayer cannot prevail. The District Court's findings and conclusions to the contrary in this respect are likewise directly against the undisputed facts, the law, and the de-

cisions, showing that the items in question represented capital contributions. The taxpayer's activities on behalf of the canneries merely thereby arranged and provided for the necessary capital for those purposes, and that constitutes capital contributions, under the statute and authorities. The loss which the taxpayer seeks to carry back and charge against income of the taxable year, therefore, is a capital investment loss which does not meet the requirements of the statute in respect of carry-back deductibility.

ARGUMENT

THE TAXPAYER IS NOT ENTITLED TO CARRY BACK AND DEDUCT FOR THE TAXABLE YEAR 1944 THE NET OPERATING LOSS ALLEGED TO HAVE BEEN SUFFERED IN 1945.

The question for decision here is whether the taxpayer is entitled to carry back and deduct from gross income for the taxable year 1944 his net operating losses alleged to have been sustained in 1945, under the carry-back provisions of Section 122 of the Internal Revenue Code (Appendix, *infra*). The taxpayer contended in the court below and the District Court decided (R. 79-82), that he could properly do so under the terms of the statute, and that therefore he is entitled to recover herein. We submit, however, that the District Court's findings and holdings to such effect are erroneous as not being supported by the undisputed facts,

and are contrary to the provisions of the statute and the controling authorities.

The statute permits taxpayers to carry back and deduct for any two preceding taxable years begun after January 1, 1941, net operating losses for the current taxable year begun after December 31, 1941, such carry-backs being limited to losses attributable to the operation of a trade or business regularly carried on by the taxpayer. Section 122 (a) to (e), inclusive, of the Internal Revenue Code. Section 122 (d) (5), however, provides that deductions otherwise allowed by law which are not attributable to the operation of a trade or business regularly carried on by an individual taxpayer (other than a corporation) shall be allowed only to the extent of the amount of the gross income which is not derived from such trade or business. Hence in order to prevail, it is incumbent upon the taxpayer to establish (a) that his activities in financing and guaranteeing the obligations of only his three wholly-owned and controlled cannery corporations during the taxable year constituted "the operation of a trade or business regularly carried on" by him, within the meaning of Section 122 (d) (5); *and also* (b) that his advancements and guaranteeing the obligations and accrued rentals of those corporations, by extending his credit and endorsing their notes in order to have the necessary operating capital to carry on their businesses, represented ordinary bad debts and not con-

tributions to capital.[11] (R. 108, 109.) The taxpayer, however, has failed to prove either proposition.

A. **The taxpayer's financing only his own corporations instead of cannery or other corporations generally, did not constitute the operation of a trade or business regularly carried on by him.**

A short resume' of the facts will readily show that the taxpayer was not engaged in the business, generally, of

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(11) It is well established that deductions are matters of legislative grace and the taxpayer must show that he comes clearly within the statute. *New Colonial Co.* v. *Helvering,* 292 U. S. 435. In order to recover, the taxpayer must establish *both* of the conditions prescribed in Section 122 for they are conjunctively stated in the statute. The taxpayer, however, has not succeeded in doing this, as we show hereinafter. Moreover, since the taxpayer is seeking to carry back and deduct net operating losses of the year 1945 against income of the taxable year 1944, he is thereby in effect making a claim in the nature of an exemption from tax under Section 122 to the extent of avoiding taxes otherwise due and payable for the taxable year, and therefore he cannot prevail for, as we shall show later, he has failed to bring himself literally within the terms of the statute allowing it. *Helvering* v. *Northwest Steel Mills,* 311 U. S. 46, 49; *United States* v. *Stewart,* 311 U. S. 60, 71; *White* v. *United States,* 305 U. S. 281, 292; *New Colonial Co.* v. *Helvering, supra;* It is settled that exemption from taxation should not rest upon implication. *United States* v. *Stewart, supra,* p. 71; *U. S. Trust Co.* v. *Helvering,* 307 U. S. 57, 60.

financing and guaranteeing the obligations of even cannery, much less other, corporations generally. The net operating losses sought to be carried back from 1945 and deducted for the taxable year 1944 are alleged to have been suffered because of the taxpayer's guarantees to pay the obligations of two of the corporations wholly owned by him which had been formed after the taxpayer had been in the cannery business for many years. He formed these two corporations —and also another which is not involved here—just prior to the taxable year involved in order to operate his canneries on a percentage-of-production basis. Prior thereto he had obtained growers' contracts which were assigned to the corporations which had no working capital or credit. The taxpayer agreed in the leases of the plants to the corporations to guarantee their obligations. The two corporations were not successful and they were liquidated. The taxpayer made advancements to them which were carried on their books as accounts payable to the taxpayer. Upon liquidation the taxpayer satisfied their outstanding obligations and it is this amount and the advancements which he claims as a carry-back loss. On these facts the taxpayer attempted to show below, and the District Court found (R. 67-68, 72, 75) and held (R. 79-80), that the taxpayer was in the business of financing canneries and thereby sustained the claimed carry-back loss, within the meaning of Section 122. The court below so found and held despite the

fact that the record shows that, according to the taxpayer's own testimony (R. 158-161), the only corporations which he endeavored to and ever did finance were his own three completely-owned and dominated canneries (R. 153-154), of which he was the sole stockholder (barring "three or four qualifying shares" held by others) (R. 108, 129, 154-155), and that he had never financed any other corporations (R. 153-154).

The primary facts relative to this issue are not in dispute. (R. 109.) They show that the taxpayer did finance, by the extension of his credit, his three wholly-owned canneries operated by him as president and chairman of the board of directors (R. 104-105, 121, 123), as the court below found (R. 68). However, the District Court's ultimate finding and conclusion that the taxpayer was engaged in the business of financing and guaranteeing the obligations of cannery corporations, generally, and therefore he was entitled to the net operating loss carry-back (R. 68, 79-80), find no support in the undisputed facts and the evidence of record, or in the statute and controlling decisions. The undisputed facts show that the taxpayer financed only his own three cannery corporations (R. 104, 133-135), and no others (R. 153-154), in order "to protect" his stock in those corporations (R. 157-158). There is no evidence whatever to show that he held himself out to the public generally as a banker, financier, or otherwise engaged in carrying on

the business of financing cannery or other corporations, generally, or that he ever promoted and financed any corporations other than his own three wholly-owned canneries. The evidence shows that he did not do so. (R. 153-154.) It also shows that the taxpayer, as sole stockholder, expanded his credit and invested the money by financing the three cannery enterprises (R. 123), which were wholly without assets or capital otherwise (R. 105, 161), in order to make them operate and pay him the lease money (R. 104), and that when they turned out to be unprofitable enterprises (R. 105-106, 125, 141), either from his standpoint as sole stockholder or from that of receiving rentals therefrom, he "sold out" the canneries and took the losses[12] (R. 104, 158-159, 160-161).

Thus, the District Court's adverse findings and conclusions, heretofore objected to, are not supported by any real evidence, much less *substantial* evidence, the preponderance of the evidence and the undisputed facts being the other way, and consequently, without the necessity of this Court's weighing the evidence at all, they should be set aside and

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(12) In this connection, the taxpayer testified on cross-examination substantially as follows (R. 158-161): In order to make the three canneries successful in their operations, the taxpayer expanded his credit and invested that money to make the enterprises work because that would be financially beneficial for him. (R. 158.) Otherwise they would not have been able to pay the taxpayer the lease money and

reversed by this Court as a matter of law.[13] As the court stated in *Cohen* v. *Commissioner,* 148 F. 2d 336, 337 (C.C.A. 2d), apropos of this, even though that conclusion was directly contrary to the testimony of the taxpayer's two witnesses, nevertheless—

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he would have received no other return from the corporations. He agreed in the leases to finance the corporations. Finally, he decided that they were not profitable enterprises, either from his standpoint as sole stockholder or from that of receiving the rentals, and therefore he "sold out" the corporations. The taxpayer was "apparently" financially able to operate the canneries himself, independently of the corporations. (R. 159.) The three corporations, however, were operating under agreements with the banks, guaranteed by the taxpayer, because he did not have sufficient money to finance the companies himself, independently of the banks. When he organized the companies he knew he had to raise the necessary funds somehow in order to get their operations started and therefore he extended his credit for that purpose, the corporations not having sufficient independent credit of their own to borrow the necessary money from the banks in order to have started operations. (R. 160.) They did not have the necessary assets for that purpose upon incorporation, and therefore the only possible way for them to get started was for the taxpayer to assist them in the financing of it. (R. 161.)

(13) As stated in several footnotes under the statement of facts, *supra,* we object to the District Court's erroneous adverse findings and conclusions, drawn from various subordinate facts, as being unsupported by the undisputed primary facts and contrary to the decisions and statute. (See fns. 3 and 5-9, *supra.*)

> * * * as we suggested in *Golden Eagle Farm Products, Inc.,* v. *Approved Dehydrating Co.,* 2 Cir. 147 F. 2d 359, footnote 1, if the uncontradicted witness rule applies at all when there is no jury, it must yield when there are facts which even indirectly may give rise to inferences contraditing the witness. In the case at bar such inferences may be drawn from undisputed facts; * * *

The Government's exceptions to the conclusions of law of the court below and its refusal to reach other conclusions in harmony with the undisputed facts, as requested, raises a substantial question of law—whether the District Court's verdict was wholly without evidence to sustain it—and consequently its general verdict is not conclusive. Since the undisputed facts show that the verdict below was without evidence to sustain it, therefore, it is proper for this Court to reverse. While findings of fact, of course, should not be disturbed if supported by substantial evidence, nevertheless it is settled that erroneous fact inferences will be set aside and corrected when not supported by the facts found, or if wrong inferences were drawn, as herein. *McCaughn* v. *Real Estate Co.,* 297 U. S. 606, 608. Moreover, the District Court's findings of fact and conclusions—that the taxpayer was engaged in the business of cannery financing regularly carried on by him—used the words of the statute, and its conclusions involve the meaning of the words found in the statutory provisions. Hence, they are questions of law, the decision of which is unembarrassed by any disputed ques-

tion of fact or any necessity to draw an inference of fact from the basic findings. Consequently, the conclusion of the District Court does not foreclose their decision by this Court. Cf. *Trust of Bingham* v. *Commissioner,* 325 U. S. 365, 371; *Rassenfoss* v. *Commissioner,* 158 F. 2d 764, 765-766 (C.C.A. 7th). Hence the District Court's application and use of the statutory words in its adverse findings of fact and the meaning thereof in its conclusions, is reviewable. Moreover, the District Court's finding that the taxpayer was engaged in such business was a conclusion, and it is settled that the findings of fact should not include conclusions of law. *Jackson* v. *United States,* 230 U. S. 1, 18.

The District Court plainly misinterpreted the words—"the operation of a trade or business regularly carried on by the taxpayer"—of the statute (Section 122 (d) (5)), and failed to apply and ignored the rules laid down in the controlling decisions, cited and relied upon by the Government in the court below. Thus, *Burnet* v. *Clark,* 287 U. S. 410, relied upon below, is a case in all material respects directly in point and is controlling here. There the taxpayer was the major stockholder, active head and president of the Bowers Southern Dredging Company. The corporation needed credit and the taxpayer endorsed the company's obligations to the bank. The assets of the corporation went into the hands of its creditors and in 1922 a new corporation was formed. The taxpayer was, in 1921, required to pay

$68,000 on the endorsements. The Commissioner disallowed a carry-over loss in 1923, claimed under Section 204 (a) and (b) of the Revenue Act of 1921, c. 136, 42 Stat. 227 (statutory provisions similar to those here involved), because the loss did not result from the operation of a "trade or business regularly carried on by the taxpayer." The Board of Tax Appeals sustained the Commissioner's determination (19 B.T.A. 859), the Court of Appeals of the District of Columbia reversed (59 F. 2d 1031), and the Supreme Court reversed the appellate court in favor of the Government, holding that the taxpayer was engaged as an officer in operating and regularly carrying on a dredging business and not the business of financing companies. The Court, quoting approvingly from the Board's opinion in that case, stated (287 U. S. 410, 413):

> "In order for the losses here involved to be deductible in determining taxable income for 1923, they must be net losses resulting from the operation of a trade or business regularly carried on by the petitioner and not from isolated and occasional transactions . . .
>
> "With respect to the loss of $68,000 resulting from the petitioner's endorsement of the Bowers Company notes, he testified that in endorsing the notes he was seeking to protect his investment in its stock. *Aside from endorsing an undisclosed number of notes of this company there is nothing in the record to indicate that acting as endorser or guarantor constituted a business or trade with the petitioner.* So far as the record shows these were the only notes ever endorsed by the petitioner

for the Bowers Company or for any other company or person. From the facts in the case we are of the opinion that *the loss did not result from the operation of a trade or business regularly carried on by the petitioner but resulted from isolated or occasional transactions . . .*" [Italics supplied.]

The Court thereupon concluded as follows (p. 415):

"*The respondent was employed as an officer of the corporation; the business which he conducted for it was not his own.* There were other stockholders. And in no sense can the corporation be regarded as his *alter ego* or agent. He treated it as a separate entity for taxation; made his own personal return and claimed losses through dealings with it. *He was not regularly engaged in endorsing notes,* or buying and selling corporate securities. *The unfortunate endorsements were no part of his ordinary business,* but occasional transactions intended to preserve the value of his investment in capital shares." [Italics supplied.]

Thus the only difference between the two cases is the immaterial one that the taxpayer there, as the principal stockholder, president and active head of the corporation, financed the *single* corporation by endorsing its obligations to the bank, whereas the taxpayer herein, as sole stockholder, did the same thing in connection with his three cannery corporations. We doubt that the taxpayer would contend that whether one or three corporations were involved, would make any difference in the result under the same factual situation. Moreover, substantially all the principal

arguments made by the taxpayer herein were likewise presented and overruled by the Supreme Court in that case.

Likewise, *Dalton* v. *Bowers,* 287 U. S. 404, contains a similar factual situation. There the taxpayer organized a corporation in 1917 which, accordingly to his testimony, was to develop and improve his patented inventions. In 1924 the corporation became hopelessly insolvent and in 1925 it passed out of existence. In 1923 and 1924 the taxpayer claimed large deductions on account of bad debts due from the corporation. In his 1925 return the taxpayer claimed a deduction of $395,000 which represented the full amount which he had paid for all the stock of the corporation. The theory on which the deduction was claimed in 1925 was that when the stock of the corporation became worthless in 1924 the taxpayer sustained a net loss in his trade or business which was deductible from 1925 income under Section 206 (a) and (b) of the Revenue Act of 1924, c. 234, 43 Stat. 253 (similar to the statutory provisions involved herein). In support of that theory, the taxpayer contended that the corporate entity constituted a part of his individual trade or business which was not merely that of inventing but included the exploiting of his inventions and developing and selling them through corporations organized for that special purpose. The Court, in holding that the loss sustained in 1924 was not a statutory net loss, pointed out that whether theoretically valid or not, the taxpayer's

argument rested on assumptions out of harmony with the facts disclosed by the record; the taxpayer was not regularly engaged in the business of buying and selling corporate stocks; the general rule for tax purposes is that a corporation is an entity distinct from its stockholders; and the circumstances there were not so unusual as to create an exception. The Supreme Court quoted approvingly from the appellate court's opinion, in respect of the taxpayer there who "paid the debts of the corporation" which he "dealt with * * * as an entity", as follows (p. 407):

> "There is no justification for saying that the business of the corporation was that of the appellee. During the period the appellee dealt with the corporation as an entity. When he paid the debts of the corporation, he drew on his personal account in favor of the corporation's account and this made the corporation his debtor. Separate tax returns were filed by the corporation and by the appellee. * * * *The loss now sought to be deducted was an investment which he made in the corporation and did not occur in the operation of the trade or business regularly carried on by the appellee . . .*" [Italics supplied.]

The Court then continued (pp. 409-410):

> "Dalton was not regularly engaged in the business of buying and selling corporate stocks. He organized the Manufacturing Corporation and took over all its shares with the intention of selling them at a profit. He treated it as something apart from his ordinary affairs, accepted credits for salaries as an officer, claimed loss to himself because of loans to it which

had become worthless, and caused it to make returns for taxation distinct from his own. *Nothing indicates that he regarded the corporation as his agent with authority to contract or act in his behalf. Ownership of all the stock is not enough to show that creation and management of the corporation was a part of his ordinary business.* Certainly, under the general rule for tax purposes a corporation is an entity distinct from its stockholders, and the circumstances here are not so unusual as to create an exception." [Italics supplied.]

In *Deputy* v. *duPont,* 308 U. S. 488, the Court denied a deduction for carrying charges, incurred by the taxpayer on sales of stock made to assist his corporation and preserve his investment in the corporation, on the ground that the taxpayer was not engaged in the business of trading in securities. The Court, following *Burnet* v. *Clark, supra,* said (pp. 493-494):

"In the first place, *the payments in question do not meet the test enunciated in Kornhauser* v. *United States,* 276 U. S. 145, *since they proximately result not from the taxpayer's business but from the business of the duPont Company.* The original transactions had their origin in an effort by that company to increase the efficiency of its management by selling its stock to certain of its key executives. The respondent undertook to furnish the necessary stock only after the company had been advised that it could not legally do so. In that posture of the case *these payments are no more deductible than were the payments made by the stockholder* in *Burnet* v. *Clark, supra,* as *a result of his endorsements of the obligations of his corporation.* Those

> payments were disallowed as deductions from his gross income though they arose out of transactions which were intended to preserve his investment in the corporation. Similar payments were disallowed in *Dalton* v. *Bowers,* 287 U. S. 404." * * * [Italics supplied.]

Mr. Justice Frankfurter, in a concurring opinion in the *duPont* case, *supra,* stated (p. 499) that—

> " 'carrying on any trade or business,' within the contemplation of Section 23 (a), involves holding one's self out to others as engaged in the selling of goods or services." * * *

To the same effect, see *Van Dyke* v. *Commissioner,* 23 B.T.A. 946, affirmed *per curiam* by this Court, 63 F. 2d 1020, and also affirmed *per curiam* by the Supreme Court, 291 U. S. 642, rehearing denied, 291 U. S. 650 (both on the authority of *Burnet* v. *Clark, supra,* and *Dalton* v. *Bowers, supra*); also *Watson* v. *Commissioner,* 124 F. 2d 437, 439 (C.C.A. 2d) (where the court stated that "Even when one man owns all the stock, he and his corporation will usually be treated as separate legal entities for tax purposes"); *Stephenson* v. *Commissioner,* 101 F. 2d 33 (C.C.A. 6th), certiorari denied, 307 U. S. 647; and *Gruver* v. *Helvering,* 70 F. 2d 292 (App. D.C.). In the *Van Dyke* case, both this Court and the Supreme Court held, under facts similar to those herein, that the taxpayer's advances to, and activities in connection with, the timber corporation there did not constitute his trade or business regularly

carried on but an investment in the company for credit. Consequently, it was held that the loss resulting from the failure of the company in the taxable year was not incurred in *his* trade or business, and therefore it could not be carried forward and deducted from his income in later years.

Several cases, such as *Kittredge* v. *Commissioner,* 88 F. 2d 632 (C.C.A. 2d); *Averill* v. *Commissioner,* 20 B.T.A. 1196, and *Conrades* v. *Commissioner,* 21 B.T.A. 213, for example, were cited and relied upon by the taxpayer in the court below but they are distinguishable on their facts and of no help to him here. Thus, the *Kittredge* case held that the basis for determining gain or loss on the sale of a winery, in 1931, should be adjusted for depreciation sustained from the property so acquired, in 1919, even though it was not used by the taxpayer or rented from 1922 to the time of the sale in 1931. The court was of the opinion (p. 634) that the phrase "used in the trade or business" in the section of the statute permitting deductions for depreciation should be read as equivalent to "devoted to the trade or business". That case did not involve the issue presented here. *Averill* v. *Commissioner, supra,* involved a taxpayer who promoted and devoted the usual business hours each day to the affairs of many diverse enterprises (approximately 35 corporations), operating each business venture through a corporation instead of as a personal venture and maintaining an office and a number of employees to carry

on such businesses. The loss sustained from the failure of one of the corporations, in 1922, was held to have resulted from the taxpayer's business and therefore properly considered in computing the amount of the net loss which could be carried forward and applied against the income of 1923 and 1924. That case, therefore, had all the statutory indicia of the operation of one's trade or business during the taxable year. However, that case (decided in 1930) was, like other cases relied upon by the taxpayer below, decided *before* the Supreme Court decided *Burnet* v. *Clark,* and *Dalton* v. *Bowers* (both *supra*) the other way in 1932, and therefore it is of doubtful value or effect herein. Moreover, such cases as *Conrades* v. *Commissioner, supra,* involved entirely different factual situations, the taxpayer there, for instance, having been actively engaged in the loan business for many years. None of the cases cited by the taxpayer below has any effective application to the facts herein or gives aid to the taxpayer.

B. The taxpayer's advancements and extension of his credit to his three wholly-owned corporations represented capital investments.

The taxpayer contended below that his advancements and obligations guaranteed to the three cannery corporations did not represent capital contributions but debts due him which became worthless during the taxable year 1945,

and therefore such net operating loss incurred in his business may properly be carried back and applied against income for the taxable years 1943 and 1944, under Sections 23 (k) and 122 of the Internal Revenue Code (Appendix, *infra*).

We have already shown under subheading A that the losses in question were "not attributable to the operation of a trade or business regularly carried on by the taxpayer", within the meaning of Section 122 (d) (5) and the controlling authorities. If more be necessary, however, we submit that the taxpayer has the burden of establishing both questions mentioned above as determinative of the issue presented herein since they are conjunctive in character—that is, whether the taxpayer's activities in guaranteeing the obligations of the three cannery corporations constituted a trade or business regularly carried on by him, *and* whether the guaranteed corporate obligations and accrued rentals represented bad debts and not contributions to capital. (R. 108, 109.) The taxpayer has met neither of these requisite burdens. If, however, it be considered that, contrary to the authorities cited above, the taxpayer's activities in making the advancements to and guaranteeing the obligations of only *his* three cannery corporations, amounted to his being a banker or financier operating and carrying on such businesses regularly, within the meaning of Section

122 (d) (5), we submit that he is still not entitled to prevail for the reason that the advancements or other items sought as carry-back deductions for the taxable year constituted in fact capital investments and not bad debts deductible under the statute.

The court below found that the sums owed the taxpayer by the three cannery corporations were unpaid balances on open accounts receivable of the taxpayer and were debts which arose in the course of his business, and not contributions to capital. (R. 72.) It therefore concluded that the taxpayer incurred the losses in his business so carried on because those debts became worthless in the taxable year 1945, within the meaning of Section 23 (k), to the end that he is entitled to the claimed net operating loss carry-back for the taxable years 1943 and 1944, under Section 122.[14] (R. 80.) The taxpayer testified that he was in the business of financing his own corporations (R. 120-121, 123, 130, 151, 156, 164), but that he had never financed any other corporations of which he did not own all the stock (R. 153-154); and he contended below that the obli-

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(14) We likewise objected to these findings and conclusions under the statement of facts, *supra.* See fns. 3, 5-9, and 13, *supra.*

gations satisfied by him constituted debts of the three cannery corporations and not capital investments. We submit, however, that the District Court's findings and con-

clusions to such effect are not supported by the undisputed facts and are contrary thereto and to the authorities, and that they are therefore reviewable and should be reversed for the same reasons as stated under subheading A, *supra,* in respect of the other adverse findings and conclusions objected to,[15] as heretofore shown.

It clearly is not important, we submit, that some of the items were carried on the corporations' books as debts due from them to the taxpayer (R. 104-105, 142-144), and that some of the obligations constituted unpaid and accrued rentals (R. 104, 124, 163), the entries of such transactions being merely evidential and not conclusive. *Gulf Oil Corp.* v. *Lewellyn,* 248 U. S. 71; *Doyle* v. *Mitchell Brothers Co.,* 247 U. S. 179. Considering substance and not mere form, as we must (*Gregory* v. *Helvering,* 293 U. S. 465; *Higgins* v. *Smith,* 308 U. S. 473; *Griffiths* v. *Commissioner,* 308 U. S. 355), and that mere legal form is not controlling (*Tyler* v. *United States,* 281 U. S. 497), it is apparent that the items in question (advancements, guaranteed obligations, etc.) constituted in effect contributions to capital and capital investment (*Dalton* v. *Bowers,* 287 U. S. 404, 407-408; *Burnet* v. *Clark,* 287 U. S. 410, 415). The record shows that it was necessary for the taxpayer to make advancements and to guarantee the obligations of his three cannery corporations in order to enable them, without other assets,

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(15) See fn. 3, *supra.*

to operate at all (R. 158-161), and that by his endorsing the notes of those corporations and standing prepared to withstand any resulting losses, he merely thereby arranged and provided for the necessary capital for that purpose, and that constitutes capital contribution. *Dalton* v. *Bowers, supra,* pp. 407-408; *Burnet* v. *Clark, supra,* p. 415; *Janeway* v. *Commissioner,* 2 T. C. 197, affirmed, 147 F. 2d 602 (C.C.A. 2d); *Cohen* v. *Commissioner,* 148 F. 2d 336 (C.C.A 2d); *American Cigar Co.* v. *Commissioner,* 66 F. 2d 425 (C.C.A. 2d), certiorari denied, 290 U. S. 699; *Corn Exchange National Bank & Trust Co.* v. *Commissioner,* 46 B.T.A. 1107.

In this connection, the Supreme Court stated in *Burnet* v. *Clark, supra,* p. 415, in respect of the taxpayer's endorsement of the corporation's obligations to the bank there, that they "were no part of his ordinary business, *but occasional transactions intended to preserve the value of his investment in capital shares.*" (Italics supplied.) Likewise, in *Dalton* v. *Bowers, supra,* the Supreme Court quoted approvingly from the appellate court's opinion in respect of the taxpayer there, who "paid the debts of the corporation", as follows (pp. 407, 408):

> "*The loss now sought to be deducted was an investment which he made in the corporation* and did not occur in the operation of the trade or business regularly carried on by the appellee . . .
>
> * * * * * *
>
> "This taxpayer did not regard the business losses

> of the Dalton Manufacturing Company as his loss. *The loss sustained by the appellee which he seeks to charge off is a capital investment loss.* The rule is well settled that the corporation will be looked upon as a legal entity . . ." [Italics supplied.]

To the same effect, see *Deputy* v. *duPont,* 308 U. S. 488, where the Court stated (p. 494) that "Those payments [made by the stockholder in the *Burnet* v. *Clark* and *Dalton* v. *Bowers* cases, *supra,* as the result of his endorsements of the obligations of his corporation] * * * arose out of transactions which were intended to preserve his investment in the corporation."

In *Janeway* v. *Commissioner, supra,* where the corporation gave the taxpayer, the sole stockholder, its notes for the advancements which he had made to it, the Circuit Court of Appeals for the Second Circuit held that such advancements to his wholly-owned corporation represented additional capital investments. In harmony therewith, the Tax Court there, apropos of the situation herein, had stated as follows (2 T.C. 197, 202-203):

> "Though the advances made were, by the issuance of the notes, given the appearance of loans, the possibility of repayment was no stronger than the business and its possible success. No other money was paid in for stock, so that *the advances constituted the corporation's only source of working capital.*" [Italics supplied.]

Likewise the taxpayer's advances to his three corporations herein were made at the risk of the businesses and

represented the required capital not otherwise paid in by him, the sole stockholder, without which they could not have operated, and consequently they represented contributions to capital. To the same effect, is *Cohen* v. *Commission, supra,* where the court held (pp. 336-337) that no part of the advances to the corporation there was a loan but that the entire sum was a capital contribution under the facts therein.

The taxpayer's arrangement under the leases with his three cannery corporations whereby he furnished all the working capital (R. 104, 123, 157, 159) and eventually, upon their liquidation, withstood all the resulting losses, might well be considered to have constituted payments made under the contracts indemnifying the corporations against losses on their notes, thereby protecting the financial interests of the taxpayer, as sole stockholder, without giving him any claim, however, against the makers of the notes. Such payments, of course, are not allowable as deductions from gross income either as business expenses or losses as bad debts. *Hickey* v. *Chahoon,* 153 F. 2d 107 (C.C.A. 2d), certiorari denied, 328 U. S. 843; *Welch* v. *Helvering,* 290 U. S. 111; *Burnet* v. *Clark, supra; In re Park's Estate,* 58 F. 2d 965 (C.C.A. 2d), certiorari denied, 287 U. S. 645; and *Howell* v. *Commissioner,* 69 F. 2d 447 (C.C.A. 8th), certiorari denied, 297 U. S. 564 (where the court held that the payment by the taxpayer, a stockholder

of the bank, pursuant to a contract to indemnify the bank against losses on certain notes, gave the taxpayer no claim against the maker of the notes, and consequently that there was no basis for deducting the payment of the losses as a bad debt). To be sure, on this basis, the taxpayer's payments of the losses on the notes, etc., constituted contributions to capital investment and not losses on bad debts.

Accordingly, it is apparent that it would be necessary to ignore completely the plain words of the statute, the controlling decisions, and the realities of the case in favor of mere form in order to hold that the taxpayer's activities in financing his three wholly-owned cannery corporations constituted his business generally and regularly carried on, and also that the advancements to the corporations, the obligation of the endorsements on their notes, and the accrued rentals at the time of their liquidation, constituted bad debts and not capital investments. The facts show that the taxpayer wished, for reasons of his own, to operate his cannery plants through wholly-owned and controlled corporations, and that however he operated them he was obliged to finance them and therefore had to endorse their notes. There is no showing whatever that he ever held himself out as a banker, financier or investment broker providing such services for canneries or other corporations, generally. As already shown, the facts do show that he never did so with any other corporations than his three

canneries in which he owned the entire stock. (R. 153-154.) The taxpayer merely raised the funds on his own credit to operate his three canneries and restricted his activities and capital contributions directly to his own enterprises. These facts are clearly insufficient, under the authorities and the taxing statute, to establish that such activities constituted carrying them on regularly as his business of alleged banker, financier or otherwise, and thereby to bring his case within the statutory requirements entitling him to carry back and deduct from the income of the taxable year 1944 the net operating losses of the year 1945, within the meaning of Section 122 of the Internal Revenue Code.

Cases relied upon by the taxpayer below, such as *Edward Katzinger Co.* v. *Commissioner,* 44 B.T.A. 533, affirmed, 129 F. 2d 74 (C.C.A. 7th), for example, are distinguishable on their facts. There the court denied the bad debt deduction claimed for 1936, the year of the liquidation and dissolution of the subsidiary corporation to which the taxpayer had made advances in prior years. A consolidated return had been filed for 1933, and the court agreed with the Commissioner that to the extent that the taxpayer had obtained a deduction on the 1933 return for the operating losses of the subsidiary, the allowance of the deduction claimed for 1936 would result in a double deduction, which the court held (p. 75) was not allowable. That question is not involved here, directly or indirectly. Other cases of like

or similar import, cited and relied upon by the taxpayer below, are likewise of no help here.

CONCLUSION

The District Court's judgment in favor of the taxpayer is incorrect and directly contrary to the undisputed facts, the applicable statute, and the controlling judicial authorities. The judgment should therefore be set aside and reversed upon appeal by this Court, and judgment entered for the Collector of Internal Revenue and the United States.

Respectfully submitted,

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APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * *

(k) [as amended by Section 124 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] BAD DEBTS.—

(1) *General rule.*—Debts which become worthless within the taxable year; * * *

* * * * * *

(4) *Non-business debts.*—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

* * * * * *

(s) [as added by Section 211 (a) of the Revenue Act of 1939, c. 247, 53 Stat. 862] *Net Operating Loss Deduction.*—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

(26 U.S.C. 1940, ed., Sec. 23.)

SEC. 122 [as added by Section 211 (b) of the Revenue Act of 1939, *supra,* and as amended by Sections 105 (e), 150 (e) and 153 (a), (b) and (c) of the Revenue Act of 1942, *supra*]. NET OPERATING LOSS DEDUCTION.

(a) *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) *Amount of Carry-Back and Carry-Over.*—

(1) *Net operating loss carry-back.*—If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss.

(2) *Net operating loss carry-over.*—If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating

loss over the net income for the intervening taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such intervening taxable year without regard to such net operating loss and without regard to any net operating loss carry-back. For the purposes of the preceding sentence, the net operating loss for any taxable year beginning after December 31, 1941 shall be reduced by the sum of the net income for each of the two preceding taxable years (computed for each such preceding taxable year with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and computed by determining the net operating loss deduction without regard to such net operating loss or to the net operating loss for the succeeding taxable year).

(c) *Amount of Net Operating Loss Deduction.*— The amount of the net operating loss deduction shall be the aggregate of the net operating loss carry-overs and of the net operating loss carry-backs to the taxable year reduced by the amount, if any, by which the net income (computed with the exceptions and limitations provided in subsection (d) (1), (2), (3), and (4)) exceeds, in the case of a taxpayer other than a corporation, the net income (computed without such deduction), or, in the case of a corporation, the normal-tax net income (computed without such deduction and without the credit provided in section 26 (e)).

(d) *Exceptions, Additions, and Limitations.*—

The exceptions, additions, and limitations referred to in subsections (a), (b), and (c) shall be as follows:

(1) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under section 114 (b) (2), (3), or (4);

(2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by this chapter, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations;

(3) No net operating loss deduction shall be allowed;

(4) Gains and losses from sales or exchanges of capital assets shall be taken into account without regard to the provisions of section 117 (b). As so computed the amount deductible on account of such losses shall not exceed the amount includible on account of such gains.

(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions,

additions, and limitations specified in paragraphs (1) to (4) of this subsection.

(6) There shall be allowed as a deduction the amount of tax imposed by Subchapter E of Chapter 2 paid or accrued within the taxable year, subject to the following rules—

(A) No reduction in such tax shall be made by reason of the credit for income, war-profits, or excess-profits taxes paid to any foreign country or possession of the United States;

(B) Such tax shall be computed without regard to the adjustments provided in section 734; and

(C) Such tax, in the case of a consolidated return for excess-profits tax purposes, shall be allocated to the members of the affiliated group under regulations prescribed by the Commissioner, with the approval of the Secretary.

(e) *No Carry-Back to Year Prior to 1941.*—As used in this section, the term "preceding taxable year" and the term "preceding taxable years" do not include any taxable year beginning prior to January 1, 1941.

(26 U.S.C. 1940 ed., Sec. 122.)